

## Message Text

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TO AMEMBASSY SANTO DOMINGO

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EXDIS

E.O. 11652: GDS

TAGS: EGEN, DR

SUBJECT: ECONOMIC PROSPECTS FOR THE DOMINICAN REPUBLIC -  
IMF AND WORLD BANK VIEWS

REFS: SANTO DOMINGO 3877, SANTO DOMINGO 3629,  
SANTO DOMINGO 3070

1. IMF AND WORLD BANK STAFF BELIEVE THE NEW GODR  
WILL HAVE TO DEAL WITH SERIOUS BALANCE OF PAYMENTS  
PROBLEMS IN THE MID-TERM FUTURE UNLESS THEY UNDERTAKE  
FAIRLY DIFFICULT REFORM MEASURES DURING THE FIRST FEW  
MONTHS OF THEIR ADMINISTRATION. THE CURRENT DRIFT OF  
THE ECONOMY IS VERY WORRISOME.

2. IMF STAFF BELIEVES THAT THE CENTRAL PROBLEM IS AN  
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UNREALISTIC EXCHANGE RATE WITH AN OFFICIALLY TOLERATED  
PARALLEL MARKET ABOUT 28 PERCENT ABOVE THE OFFICIAL  
PARITY. THIS GAP CONTINUES TO WIDEN AND THREATENS  
TO BECOME UNSUSTAINABLE. UNDER THE BALAGUER GOVERNMENT  
THE EXCHANGE RATE AND BALANCE OF PAYMENTS WERE  
PROTECTED THROUGH VERY CAUTIOUS FISCAL, MONETARY AND  
INCOMES POLICIES. DURING A NEW ADMINISTRATION,

CONSERVATIVE DOMESTIC ECONOMIC POLICIES WILL BE MUCH MORE DIFFICULT TO CARRY OUT AS ASPIRATIONS HAVE RISEN AND CONTROL IS EXPECTED TO BE LESS RIGID. THE GUZMAN GOVERNMENT IS ALREADY SADDLED WITH RECENT PAY INCREASES FOR POLICE AND MILITARY AND OTHER INCREASED GOVERNMENT EXPENDITURES WHICH THEY MAY NOT BE ABLE TO REVERSE. THE STRAIN WILL EVENTUALLY SHOW UP IN THE BALANCE OF PAYMENTS.

3. IN AUGUST 1977 ARTICLE VIII NEGOTIATIONS, THE IMF WARNED THE DOMINICANS ABOUT THE NEED FOR ADJUSTMENT AND ENCOURAGED THEM TO ESTABLISH A UNIFIED EXCHANGE MARKET. BUT AS YET NO MOVEMENT HAS BEEN SEEN IN THIS DIRECTION. THERE MAY BE A UNIQUE OPPORTUNITY AT THE OUTSET OF THE GUZMAN ADMINISTRATION TO TAKE UNPOPULAR BUT NECESSARY ECONOMIC MEASURES WHILE ATTRIBUTING THE NEED FOR THEM TO THE OUTGOING BALAGUER ADMINISTRATION.

4. OF PARTICULAR CONCERN ARE THE PRESENT ARREARAGES IN PAYMENTS WHICH AMOUNT TO PERHAPS \$20 TO \$25 MILLION TO SEVERAL NEW YORK COMMERCIAL BANKS. ALTHOUGH SHORT-TERM ARREARAGES HAVE TRADITIONALLY BEEN A PROBLEM OF BUREAUCRATIC INEFFICIENCY, NON-PAYMENT IN THE LAST FIVE MONTHS HAS ASSUMED THE PROPORTIONS OF DEFAULTING ON CERTAIN LOANS AND THREATEN THE DR'S INTERNATIONAL CONFIDENTIAL

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CREDIT RATING. THESE ARREARAGES MAY WELL OFFSET THE FAVORABLE EFFECT OF THE DR'S LOW DEBT SERVICE RATION (7.7 PERCENT) TO MAKE PRIVATE BORROWING DIFFICULT WHEN IT BECOMES NECESSARY IN THE FUTURE.

5. THE IMF HAS LIMITED INFLUENCE AT PRESENT SINCE THE DR HAS AVOIDED UTILIZATION OF IMF CREDIT FACILITIES INVOLVING CONDITIONALITY. HOWEVER, FUND REPRESENTATIVES THINK THE DR WILL EVENTUALLY HAVE TO COME TO IMF AFTER THE BALANCE OF PAYMENTS SITUATION BECOMES MORE CRITICAL AND MORE SUBSTANTIAL CORRECTIVE MEASURES ARE NEEDED. IMF PROJECTIONS SHOW POSSIBLE CURRENT ACCOUNT DEFICIT OF \$360 MILLION FOR 1978. FURTHERMORE, PROSPECTS FOR THE DR IN 1979 SUGGEST WORSENING AS EARNINGS FROM TRADITIONAL EXPORTS WEAKEN. CONTINUED DETERIORATION COULD LEAD TO JAMAICA-TYPE SITUATION IN ONE OR TWO YEARS.

6. THE WORLD BANK AGREES THAT THE CURRENT DIRECTION OF THE ECONOMY WILL RESULT IN BALANCE OF PAYMENT DIFFICULTIES IF CURRENT ECONOMIC POLICIES ARE

CONTINUED. HOWEVER, THE BANK BELIEVES THAT REALIGNMENT OF THE EXCHANGE RATE COULD BE UNDERTAKEN MORE GRADUALLY IF COUPLED WITH OTHER ADJUSTMENTS AND COORDINATED IN A COMPREHENSIVE ECONOMIC DEVELOPMENT PLAN.

7. UNDER PRESENT POLICIES, THE WORLD BANK BELIEVES THAT THE CURRENT ACCOUNT DEFICIT FOR THE DR WILL BE AROUND \$344 MILLION IN 1978. IT ALSO THINKS THAT A FOREIGN EXCHANGE RESOURCE GAP OF 4 TO 5 PERCENT OF GDP OVER THE NEXT FIVE TO EIGHT YEARS WILL DEVELOP. THUS, EVEN WITH MAXIMUM BORROWING, GROWTH WILL BE HELD TO ABOUT THREE PERCENT ANNUALLY DURING THIS PERIOD. A PROSPECT LIKELY TO BE UNACCEPTABLE TO THE NEW ADMINISTRATION. BY 1985, THE DEBT/SERVICE RATIO  
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COULD CLIMB TO 23 PERCENT ASSUMING THAT THE GODR PICKS UP ALL EXTERNAL DEBT AVAILABLE.

8. THE BANK SEES A PRESCRIPTION FOR ECONOMIC HEALTH FOR THE DOMINICAN REPUBLIC CONSISTING OF:

A. A GRADUAL ADJUSTMENT OF EFFECTIVE EXCHANGE RATE BY MOVING ALL IMPORTS INTO THE PARALLEL MARKET EXCEPT FOR WHEAT AND A SMALL NUMBER OF OTHER POLITICALLY PRICE-SENSITIVE ITEMS. UNDER THIS SCENARIO, ALL EXPORTS WOULD ALSO BE PUT IN THE "GRAY" MARKET WITH THE POSSIBLE EXCEPTION OF SUGAR. THIS EXPANSION OF THE PARALLEL MARKET WOULD BE A LARGE INCENTIVE FOR EXPORTS RESULTING IN A HEALTHIER TRADE PICTURE.

B. CREATING A COMPREHENSIVE DEVELOPMENT AND INVESTMENT PLAN FOR THE MEDIUM TERM. AT PRESENT THE WORLD BANK SEES THE LACK OF A REALISTIC AND COORDINATED INVESTMENT PLAN AS THE REASON BEHIND SEVERAL FAULTY JUDGMENTS IN THE PAST.

C. INCREASING INCENTIVES FOR EMPLOYMENT-CREATING EXPORT INVESTMENTS. THIS COULD BE DONE BY THE NEW GOVERNMENT REASSURING INVESTORS WHILE REPEALING LAW 299 WHICH SUBSIDIZES INEFFICIENT IMPORT SUBSTITUTION INDUSTRIES. AS A FAVORABLE EXAMPLE, THE BANK POINTS TO THE FREE TRADE ZONES WHICH ALONE HAVE ACCOUNTED

FOR STRONG GROWTH OF CERTAIN EXPORT-ORIENTED INDUSTRIES.

9. WHILE THE BANK BELIEVES THAT THE DR COULD POSSIBLY SLIDE INTO A SERIOUS BALANCE OF PAYMENTS SITUATION, THEIR EVALUATION IS NOT AS BLEAK AS THE IMF'S ASSESS-  
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MENT. PRIVATE INVESTMENT FLOWS ARE STILL AVAILABLE FOR THE DR AND CAN BE ENCOURAGED. THE PROBLEM IS THAT A CLOSED ECONOMY HAS BEEN ESTABLISHED THROUGH THE EXCHANGE RATE POLICY AND THERE IS LITTLE INCENTIVE FOR GROWTH.

10. A MAIN CONCERN OF THE IMF STAFF AT THIS POINT IS THAT OTHER POSSIBLE SOURCES OF EXTERNAL FINANCING, INCLUDING THE USG, MIGHT HOLD OUT PROMISES OF ECONOMIC ASSISTANCE WHICH WOULD BE ONLY STOPGAP AND MIGHT ENCOURAGE THE DOMINICANS TO AVOID ADDRESSING THE STRUCTURAL PROBLEMS. BOTH THE FUND AND THE BANK AGREE THAT THE TIME FOR REFORM IS NOW.

11. THE ABOVE IS FOR POST INFORMATION AND COMMENT ONLY, AND SHOULD NOT BE DISCUSSED WITH THE GODR AT THIS TIME. IN NO CASE SHOULD USG DISCUSSIONS WITH IMF/IBRD STAFF BE REVEALED. EMBASSY'S COMMENTS WOULD BE APPRECIATED. CHRISTOPHER

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